The State Franchise Fee and Emerging Technology Companies

Creating success in the best of environments is challenging. I believe that the #1 job of today's leaders is to remove any impediments to success that we can. I also believe this is true in State leadership as well. I would like to share with you what I believe is a serious impediment to Michigan's success in attracting emerging technology companies.

That issue is the cost of the Michigan's Franchise Fee on the stock of emerging companies like ours (LeanLogistics, Inc.). The issue is that Michigan charges companies a franchise fee solely based on the number of shares that it issues. There is no calibration for capitalization, profitability, or anything else, save how many shares that it authorized when it was formed.

Today, an emerging technology company has to structure itself for success in its capital structure. In doing so it may have to provide for several rounds of financing and an option pool to align its associates with those of its shareholders. This requires issuing shares of stock. Let me give you an example:

A company, let's call them "MedTech", is formed in Michigan to take advantage of some unique technology discovered thru research at one of the state's universities. It signs a licensing agreement with the University to transfer the technology and raises $1 million dollars of initial capital. In anticipation of the multiple rounds of financing that would be required, a pool of stock options for its employees and a dreamed of Initial Public Offering (IPO), it incorporates and authorizes the issuance of 30 million shares. The seed round investors are issued 1 million shares at $1.00 per share to reflect their investment, leaving 29 million shares remaining in MedTech's treasury.

As a dutiful corporate citizen, it files its Annual Report with the State of Michigan indicating its corporate officers, its apportionment percentage (100% since they have now received their first dollar of revenue from a Michigan company) and its stock structure (30 million shares). Now, imagine their surprise when the State's Department of Consumer & Industry Services informs them that they owe $35,000 in taxes in 30 days!

Well, here is the logic: "fees payable on the increase in attributable shares are computed at the rate of $30.00 for each additional 20,000 shares or a portion thereof up to a maximum fee of $5,000.00 for 10,000,000 shares. For shares in excess of 10,000,000, the fee shall be $5,000.00 plus $30.00 for each 20,000 attributable shares or portion thereof in excess of 10,000,000, up to a maximum of $200,000.00 per filing."

MedTech's report reflected an increase in authorized shares attributable to Michigan shares since they were a new company (increased from 0 shares) on which a $35,000.00 fee would be payable. This is the same with us at LeanLogistics.

That amount may not seem like much from the state's point of view, but it represents one month's payroll to a company like LeanLogistics struggling to make a difference in this state.

I do not believe that it helps create the kind of corporate environment that Michigan will need for its long-term success.

The interesting thing is that it doesn't make any difference where the company incorporates; the franchise fee is calculated on the proportion of business done in the state of Michigan period.

Well, how do other states calculate their fees?

Delaware uses a system that charges an organizational tax and then an annual fee. The annual fee can be calculated by two different methods, and companies are allowed to pay the cheaper of the two. The first method charges a dollar amount based solely on authorized shares. The second method, often called the assumed par value capital method, uses a company's total gross assets, and this often results in a lower payment for a young company.

Michigan uses a system based on authorized shares. Initially, a foreign corporation can calculate the test using 60,000 shares no matter how many shares it actually has outstanding. One would think that a young company may try to take advantage of this by authorizing a large number of shares in its initial filing. Unfortunately, the realities young technology companies face in attracting investment often make this impossible as investors are concerned about dilution from large authorized share numbers. Moreover, most young technology companies increase their authorized share numbers several times during the early stage of their life cycle as they attract investors or establish new or enhanced employee equity incentive programs. A young technology company can face a significant charge under the system used in Michigan upon each one of these increases. In fact on the first such increase, these companies face a fee based on every authorized share in excess of 60,000 shares.

A Delaware Example:

To help illustrate this, it can be very common for a young technology company (I will call it TechCo) to be incorporated with a total of

15,000,000 authorized shares of capital stock, split between 10,000,000 shares of Common Stock and 5,000,000 shares of Preferred Stock, each with a par value of $0.0001. Emerging growth companies typically utilize large authorized share numbers since it enables them to offer attractively sized equity awards to employees to compensate for lower salaries. Also, the authorized share numbers are often increased during investment rounds in order to sell the negotiated amount of equity. For instance, it would not be uncommon for TechCo to complete a financing with a total of 30,000,000 authorized shares of capital stock, split between 20,000,000 shares of Common Stock and 10,000,000 shares of Preferred Stock. I will assume that TechCo completes the financing with total gross assets of $2,000,000 and total issued shares of 8,500,000.

Assuming it was incorporated in Delaware, TechCo would owe an organizational fee of $0.02 per $100 for the first $2,000,000 of authorized par value stock, with a minimum fee of $15. At organization TechCo has authorized par value stock of $1,500 (15,000,000 * $0.0001). This results in an organizational fee of $15.00. Following the financing described in the preceding paragraph, TechCo would use the alternative assumed par value capital method and be charged an annual fee of approximately $1,400. This is calculated from dividing the total gross assets ($2,000,000) by the total issued shares (8,500,000), taking the result ($0.235) and multiplying it by the total authorized shares (30,000,000), then taking the result ($7,058,824) and paying a tax of $200 per each million dollars.

Result of Delaware Example Compared to Michigan - Savings for Young Companies:

In Delaware, TechCo would pay approximately $1,415 in the first year and amounts close to $1,400 each year thereafter. The exact annual amount would depend on the amount of future equity increases.

In Michigan, TechCo would pay an initial fee of $50 and, following the financing described above, $35,000. TechCo would also be required to pay additional multi-thousand dollar payments when it increased its share capital for new investment rounds or equity incentive plan increases.

In summary, it would take TechCo under the Delaware system over 20 years to match even the initial $35,000 Michigan payment. In addition, the time value of money means that the Delaware payment method actually results in a savings to TechCo during that 20 year period. Assuming a 6% interest rate, the present discounted value of the cash flow during the 20 year period is less than $20,000.00. This further demonstrates the value of the Delaware style system to a young company on a conservative expense budget.

Closing example with California:

Other states have adopted systems that, while different from Delaware, have aided young technology companies. For example, most people would agree that it would be fair to state that California has been able to attract perhaps the most significant number of technology companies throughout the country. California's franchise tax system also is geared to be helpful to young companies during their early cash-restricted days. No initial fees are imposed upon organization. A tax based on net income is imposed annually with a minimum tax of $800 per year. However, no amounts are due during the first two years.